Colonial First State
Global Asset Management

Franking Credits – Is it time to stop the chase?

Media release

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Chasing franking credits may lead to investors achieving lower after tax returns, research from Colonial First State Global Asset Management has revealed.

The research paper, *How tax effective are franking credits?,* challenges the effectiveness of franking credits in maximising tax efficiency and argues that franked dividends generally do not provide investors that pay tax with tax-effective returns on their investment.

Franking credits are the means by which the double taxation of dividends is avoided in Australia. They have traditionally been regarded as an important tool in the armoury of investors seeking to boost the after tax return in their investment portfolio. They are valuable because they represent company tax already paid and therefore reduce the Australian tax bills of shareholders. Since tax law allows Australian resident investors to claim the credit even if they pay no other tax, franking credits can remain a useful tool to boost the after tax return of a portfolio.

However, CFS GAM's Head of Investment Research and Development, Aaron Minney, points out that the market assigns a value to franking credits in share prices and so share markets are actually paying for a significant portion of the credit. This has the effect of reducing the potential capital gain from a share holding, which is often the most tax-efficient manner for investors to receive returns. For this reason, Mr Minney argues, it's no longer clear if investors really *do* maximise their tax efficiency by targeting franking credits in their investment strategy.

"The market does give a small discount for franking and dividends, but the discount is not proportional – stocks with more franking attached to the dividend receive a smaller discount, and vice versa. Investors who chase stocks with more franking will get a smaller discount than if they had concentrated on those with smaller franking levels. The bigger discount provides for a better after tax return. So – the net result is that chasing franking credits will actually lead you to *lower* after tax returns," said Minney.

The paper also flags the importance of being aware of other available discounts, and their relative value in the investment, when franking credits are involved. In the case of franking credits, the cost represents the loss of potential capital gain, which is discounted for tax purposes if the asset is held longer than one year. It is possible that a greater tax benefit is foregone with the capital gain than is received with the franking credit.

Without short-changing the inherent value of franking credits, Minney cautions investors to stay focused on the core elements of investment. "Ultimately it's factors like the underlying performance of the stock, diversity of portfolio and the active management of that portfolio that should be the primary drivers for investors looking to maximise their return. Franking credits need to be considered in addition to this context, not as a primary lever," he said.

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About Colonial First State Global Asset Management

Colonial First State Global Asset Management is the consolidated asset management division of the Commonwealth Bank of Australia Group, one of the largest financial institutions in Australia. Colonial First State Global Asset Management is Australia's largest manager of Australian sourced funds, employing more than 200 investment professionals.

At 31 December 2009, Colonial First State Global Asset Management managed more than A$149 billion across a diverse range of asset classes including Australian and global shares, short term investments, fixed interest and credit, property securities, direct property, global resources, unlisted infrastructure and listed infrastructure securities.

In March 2007, Colonial First State Global Asset Management signed the UN Principles for Responsible Investment, which provide a framework for including environmental, social and governance issues for investment decisions. Colonial First State Global Asset Management has undertaken to utilise this framework for the funds for which it provides investment management services.